Direct Energy

June 29, 2006

DIRECT ENERGY (2nd) PRELIMINARY COMMENTS

OEB STAFF Draft 2 – June 20, 2006 DISCUSSION PAPER
OPTIONS FOR SETTING PAYMENTS FOR OPG PRESCRIBED ASSET OUTPUT

Direct Energy has previously provided preliminary comments in this matter, in reference to Draft 1 (May 8, 2006) of Board Staff's discussion paper. A copy of those first comments is attached. The same concerns apply in respect of the second draft paper. In particular:

- The characterization of the Board's statutory objectives continues to be too narrow. The promotion of economic efficiency and cost effectiveness, and the maintenance of financial viability in Ontario's electricity industry necessarily involve consideration of the impact of Board decisions on the wholesale and retail electricity market. A functioning forward wholesale power market is essential to:

  - Provide generation investors with the tools to manage, and thus assume, investment risks. The greatest single exigency facing Ontario's power market today is the need to secure cost effective, and economically efficient, investment in new generation. Failure to attract private risk capital will result in taxpayers and ratepayers bearing tens of billions of dollars of investment risk and in unnecessary diversion of scarce public funds.

  - Provide liquidity to support alternative supply and pricing options for customers. Without forward supply retail supply options will be removed from the market.

- The generic references in the draft paper to the "significant complexities" associated with the "regulatory contract" option (see pages 10 and 11) are curious. The generation facilities in question are currently operating under such a structure. We also note the discussion in the paper (see for example page 9) of mechanisms to "sculpt" payments to OPG to incent certain bidding behaviour. This is precisely the sort of mechanism one would expect in a "regulatory contract" structure.

Direct Energy has additional concerns in respect of the second draft paper. In particular:

- The proposition (see page 10 of the draft paper) that there is lack of specific policy direction in regard to whether a market is part of Ontario's electricity future is simply incorrect. The legislation clearly contemplates, and the Minister of Energy has expressly and repeatedly emphasized, the "hybrid" nature of Ontario's restructured electricity sector – part regulated and part competitive. To ignore this policy context is not "policy neutral", but rather is <u>contrary</u> to clearly stated government policy.

  - There is no discussion under the incentive regulation model of how the output from OPG's plants would be put into the real time wholesale electricity market, how market prices paid for that output would be settled, and how this would differ under a "regulatory contract" model.

- The proposition is made (page 10, 3rd paragraph) that incentive regulation should consider regulatory incentives to substitute for market signals to influence operating decisions. Of course, we have an actual wholesale market, and actual market signals. Market signals are better suited than regulatory approximations to incent efficient and customer responsive behaviours.

- The proposition is made (page 12, 3rd full paragraph) that:

  > *The fact that the prescribed assets are under rate regulation in and of itself is indicative of a move away from market pricing as the primary basis for the remuneration of their output. If market based pricing was the intended outcome, there would be little need for (or value in) regulatory review of the payments amounts.*

  The matter under consideration is <u>not</u> the price at which the output is sold into the market, but rather the payments to be made to OPG on account of that output. The foregoing proposition ignores this distinction, and fails to recognize that the prescribed assets have a necessary connection to the market.

- The essential issue to consider under the rubric of a "regulatory contract" model is whether, and if so how, the output from Ontario's base load generation assets is put into the wholesale real time and forward markets. Direct Energy notes that the OPA and the IESO, the two agencies charged with the public interest in effective management of the market part of "hybrid" structure, have strongly indicated that the "regulatory contract" model bears further discussion and consideration.

- There is a lack of clarity regarding the essential elements of the "regulatory contract" option, versus the other options. For example:

  - There is a concern regarding the appropriateness of relying on "negotiations" between parties to determine the parameters for the "regulatory contract". It is <u>not</u> necessary that the terms of the arrangement would be negotiated between commercial parties. Under the model currently in place, which is essentially a "regulatory contract" model, the government established all of the salient terms and conditions. The Board could do so going forward (as acknowledged in the paper, see page 17, 2nd full paragraph).

  - The notion of a "regulatory contract" is not inconsistent with an incentive regulation type mechanism to establish the OPG earnings to be allowed under the arrangement.

Direct Energy is also concerned with the time frames proposed for this critical decision.

- While we appreciate the open and consultative approach that Board Staff have taken in this matter to date, the time frames for comment have been too tight. This is a matter of fundamental importance to electricity consumers and the future of our electricity sector.

- This policy decision should not be made without consideration of the OPA's market evolution plan, which is expected to be articulated in the Integrated Power System Plan (IPSP) to be released later in the summer. As already noted, disposition of the output OPG's base load assets is a critical component in considering the ongoing viability and efficiency of Ontario's electricity market.